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No. 60

In the Supreme Court of the United States

OCTOBER TERM, 1930

EUGENE DENMAN, ADMINISTRATOR OF THE ESTATE OF CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

v.

W. L. SLAYTON

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum opinion of the District Court (R. 4) is not reported. The opinion of the Circuit Court of Appeals (R. 9) is reported in 36 F. (2d) 145.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth Circuit was entered December 6, 1929. (R. 9.) Petition for certiorari was filed on March 6, 1930, and certiorari was granted on April 28, 1930. (R. 14.) The jurisdiction of this Court is

invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is it within the constitutional power of Congress to deny taxpayers, in the computation of taxable net income, the right to deduct interest paid on indebtedness incurred to purchase or carry State and municipal bonds, while permitting the deduction of other interest paid?

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 238, 239, provides:

> SEC. 213. That for the purposes of this title * * * the term "gross income"—
>
> * * * * *
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or of the District of Columbia; * * *
>
> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities

> (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; * * *.

STATEMENT

The case was decided in the District Court on demurrer to a petition which set forth the following facts (R. 1-4):

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds, particularly municipal bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income, the source of which is not disclosed by the record, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy, carry, and sell the municipal bonds the sum of $78,152.84. In making his income-tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds. (R. 1.)

Upon review and audit of this return, the Commissioner of Internal Revenue disallowed this deduction and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest, amounting to $7,778.04, the respondent

paid on demand under protest on August 4, 1927. (R. 1, 2.) He then filed a claim for refund and upon its rejection (R. 3) brought suit against the Collector in the United States District Court for the Northern District of Ohio to recover the sum so paid (R. 1). The Collector's demurrer was overruled and judgment was entered for the respondent. (R. 5.) The Circuit Court of Appeals affirmed the judgment. (R. 9–13.)

The trial court took the view that the statute would be unconstitutional if applied to the admitted facts, and held that it had no application. The Circuit Court of Appeals held that the statute does apply and that under the authority of *National Life Insurance Company* v. *United States*, 277 U. S. 508, it is unconstitutional in that it seeks to impose a direct tax upon income from State obligations.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that Congress could not constitutionally refuse to permit, in computation of taxable net income, the deduction of interest paid on indebtedness incurred to purchase and carry tax-exempt bonds, while allowing the deduction of other interest paid.

SUMMARY OF ARGUMENT

1. The statute applies to a dealer in municipal bonds as well as to a private investor. The court below so held.

A deduction for interest paid can not be taken as a business expense under Section 214 (a) (1) of the Revenue Act of 1921. In the Revenue Acts the two classes of deduction have always been distinguished and have been separately provided for. The very provision as to the exception here involved shows an intent to allow them as distinct items of deduction.

2. The statute does not operate to impose a direct tax on income from municipal bonds or to impose an appreciable burden upon the borrowing power of the State. The case differs from *National Life Insurance Company* v. *United States,* 277 U. S. 508, *supra,* in that there the exclusion from income of tax-free interest was exactly offset by a corresponding diminution of another item of deduction, while here there is no exact relation or even necessary relation between the exclusion of tax-free interest from income and the denial of a deduction of interest paid to buy or carry tax-free bonds. The limitation does not affect one who receives tax-free interest differently from one who does not.

The limitation is not a burden upon the borrowing power of the States, for it has no relation to the exercise of that power, and has not in fact affected it.

3. The classification is just and reasonable. Taxpayers have no inherent right to deductions. Congress may classify incomes for purposes of taxation and may limit deductions of interest. Other similar classifications have been made.

If any portion of the interest paid was chargeable to purposes other than buying and carrying tax-free bonds, the amount of it does not appear. In any event, taxing statutes can not be applied with mathematical exactness. That the statute may work an occasional hardship does not condemn it.

Every presumption is in favor of the constitutionality of the Act.

ARGUMENT

I

THE EXCEPTION IN SECTION 214 (a) (2) MAY NOT BE DISREGARDED, EITHER ON THE THEORY THAT IT DOES NOT INCLUDE INTEREST PAID BY DEALERS OR ON THE THEORY THAT SUCH INTEREST IS DEDUCTIBLE AS A BUSINESS EXPENSE

Section 213 (b) (4) of the Revenue Act of 1921 (p. 2, *supra*), excludes from gross income the interest derived from obligations of a State or a political subdivision thereof. Section 214 (a) (2) of the same Act allows as a deduction, in computing net income, all interest except that paid on indebtedness incurred or continued to purchase or carry securities the interest from which is wholly exempt from tax.

The court below held that the statute is unambiguous and that it plainly applies to all interest paid to purchase or carry tax-free securities, whether by a private investor or by a dealer. The point hardly requires argument. If the taxpayer should contend that the statute has no application here because of the allegation in the petition in

the District Court that money was borrowed and interest paid thereon for the purpose, *inter alia,* of "selling" tax-free securities, two answers occur: (1) No interest obligation can possibly be incurred in selling bonds, and (2) if it was, it would seem the burden was on taxpayer to plead how much of the interest payments here involved are chargeable to that activity.

The further contention was made by the taxpayer in the court below and is made in the brief of *amici curiae* here, that since the interest was paid by the taxpayer in connection with his business as a dealer in securities it does not fall within the provisions of Section 214 (a) (2) of the Revenue Act of 1921, but is deductible as an ordinary and necessary expense in carrying on the business under the provisions of Section 214 (a) (1) of the same Act.

The deduction of interest payments has always been provided for separately from the deduction of business expenses. Act of October 3, 1913, c. 16, 38 Stat. 114, 166, Sec. II, B; Revenue Act of 1916, c. 463, 39 Stat. 756, Sec. 5 (a) Second, as amended by Revenue Act of 1917, c. 63, 40 Stat. 300, 330, Sec. 1201 (1); Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066, Sec. 214 (a) (2); Revenue Act of 1921, c. 136, 42 Stat. 227, 239, Sec. 214 (a) (2). In the Regulations, deductions of interest are dealt with separately from deductions for business expenses. Regulations 62 (1922 ed.), Articles 101, 121. The

very provision as to the exception here involved shows an intent to allow them as distinct items of deduction. The separation of the two classes of deductions is as distinct here as it was in the Corporation Tax Act of August 5, 1909 (36 Stat. 11, 112, c. 6, Sec. 38), construed by this Court in *Anderson* v. *Forty-two Broadway Company*, 239 U. S. 69.

II

THE ACT IS NOT UNCONSTITUTIONAL AS TAXING A STATE INSTRUMENTALITY

Because of the implied prohibition in the Constitution against interference by the Federal Government with the functioning of the governments of the States, a tax is invalid if it is a direct tax upon an instrumentality of a State or if it imposes a burden upon its borrowing power. We submit that the refusal of Congress to permit the deduction of the interest payment here in question does not so operate.

The court below held that the refusal to allow the deduction constituted a direct tax on the income from municipal securities, and relied on the case of *National Life Insurance Company* v. *United States*, 277 U. S. 508, *supra*. That case involved the constitutionality of Section 245 of the Revenue Act of 1921, c. 136, 42 Stat. 227, 261, which defines net income of life-insurance companies, for income tax purposes, as the gross income less certain deductions, among them being (1) the amount of interest received during the taxable year from tax-exempt

securities, and (2) an amount equal to four per cent. of the company's mean reserve funds, provided that the amount of this deduction be diminished by the amount of the first deduction, i. e., the interest from tax-exempt securities. The result was that the deduction of the exempt interest from gross income was exactly offset by the elimination of an equal amount from the deduction otherwise allowed by the statute. In practice, therefore, an insurance company holding tax-exempt securities was required to pay exactly the same amount of income tax that it would have paid had the securities been taxable instead of exempt, and this Court held that the statute in effect imposed a direct tax upon income from the exempt securities and was therefore invalid.

Here the situation is different. The statute has neither direct effect nor remote effect upon the owner of exempt securities who does not borrow to buy or carry them. When an owner of such securities does borrow, the statute does not affect the exemption to which he is entitled, but it does affect the amount of his allowable deduction in a manner having neither exact nor necessary relation to the amount of his income from exempt sources. The amounts borrowed to buy or carry the exempt securities may be but a small percentage of the actual cost of the securities. The interest rates for the borrowed money are probably greater, in most instances, than the interest rates of the exempt securities, but the total interest received may exceed

greatly the total interest paid, this depending largely upon the relation of the total amount borrowed to the total purchase price. Thus it is clear that in refusing to allow deductions for interest paid to buy or carry exempt securities Congress has made no effort to offset, even approximately, the interest received from such securities, and there is no indication of the intention to produce, nor is there produced, a result which amounts to a tax, direct or indirect, on the exempt income.

Nor is the case of *Missouri* v. *Gehner*, 281 U. S. 313, controlling here. The operation of the State taxing statute there involved was, as held by the Court, directly and necessarily to include in the value of the property taxed a definite proportion of the United States bonds owned by the taxpayer. There, ownership of such bonds inevitably resulted in the inclusion of a portion of their value, whereas here neither the ownership of the bonds nor the receipt of income from them results in an increased tax, and the taxpayer is affected at all only if he has borrowed capital for their purchase.

The limitation under consideration appeared first in Section 1201 of the Revenue Act of 1917, c. 63, 40 Stat. 300, 330, and it has appeared in all subsequent Revenue Acts. The intent which prompted its enactment is reflected in the report of the Senate Finance Committee relating to Section 214 (a) (2) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1060), which is substantially the same

as Section 214 (a) (2) of the 1921 Act, *supra*. The report (Senate Report No. 617, 65th Congress, Third Session, p. 6) said:

> The interest deduction (sec. 214a, 2, and sec. 234a, 2) has been amended so as not to permit a deduction for interest on indebtedness incurred or continued to purchase or carry tax-free securities other than obligations of the United States issued after September 24, 1917. This limitation is substantially the same as the one contained in the present law. The provision of the House Bill which allows a deduction for interest on all indebtedness permits the taxpayer to make loans for purchases of wholly exempt securities and then deduct the interest paid on such loans from his otherwise taxable income, thereby reducing his tax. The limitation suggested above would operate to discourage this practice except in the case of the later issue of liberty bonds.

In the *National Life Insurance Co.* case, the effect of the statute was to increase the normal taxable basis (net income) so that the total was the same as if the exempt income were itself taxed. In the present case, on the other hand, the statute merely refuses to permit the further reduction of the normal taxable basis by payments made to buy or carry exempt securities. The basis is left as it would have been had no money been borrowed for such carrying purposes, even though exempt securities were purchased and held and income was

derived therefrom. While in the *National Life Insurance Co.* case, therefore, the inevitable effect of holding exempt securities was to increase the burden upon taxable property, the section involved in the instant case merely leaves the taxpayer to carry his self-imposed burden of borrowing charges without receiving a deduction allowance therefor. His income from exempt securities is untouched, no matter how much it may exceed (or be exceeded by) his borrowing and carrying charges, and in computing his income he receives the same deductions and pays the same tax as anyone else. What respondent claims is an additional benefit because he incurred indebtedness for tax-free securities; but Congress is under no duty to offer special advantages to the holders of exempt securities. Cf. *Florida* v. *Mellon*, 273 U. S. 12, 17.

Nor can it reasonably be contended that the statute imposes a direct or appreciable burden upon the borrowing power of the State. It must first appear that the operation of the statute has some necessary relation to the exercise of that power. No such relation appears here. The borrowing of money is not a necessary concomitant of the purchase and ownership of municipal bonds.

Experience does not indicate that the disallowance of the deduction of interest paid to purchase or carry tax-exempt securities, which began with the Revenue Act of 1917, *supra*, has caused any

substantial impairment of the borrowing power of the States and their municipalities.[1]

As said by this Court in *Plummer* v. *Coler*, 178 U. S. 115, 137–138:

> But when the effort is made, as is the case here, to establish the unconstitutional character of a particular tax by claiming that its remote effect will be to impair the borrowing power of the government, courts in overturning statutes, long established and within the ordinary sphere of state legislation, ought to have something more substantial to act upon than mere conjecture. The injury ought to be obvious and appreciable.

The Court also said (p. 136):

> * * * the mischief to our national credit, so feelingly deplored in the briefs, caused by state taxation upon estates of decedents, would be inappreciable, and too remote and uncertain to justify us now in condemning the tax system of the State of New York.

See also *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 523; *Heiner* v. *Colonial Trust Company*, 275 U. S. 232, 235.

III

THE CLASSIFICATION IS REASONABLE AND JUST

The general purpose of the allowance of deductions in computing net income is to reduce the tax-

[1] The Report of the Secretary of the Treasury for the year ended June 30, 1929, page 533, Table 61, shows a constant increase of estimated net outstanding indebtedness of States and their municipalities from $[illegible]07,000,000 on June 30, 1917, to $13,404,000,000 on June 30, 1929.

able income by the amount of expenditures made in its production. But taxpayers have no inherent right to deductions and the allowance of deductions is a matter of legislative discretion. *New Creek Co.* v. *Lederer* (C. C. A. 3rd), 295 Fed. 433, 435, certiorari denied, 265 U. S. 581; *Consolidated Gas, Electric Light & Power Co.* v. *United States*, 65 C. Cls. 252, 259, certiorari denied, 278 U. S. 612. Likewise, Congress may limit the amount of interest which may be deducted from gross income. See *Anderson* v. *Forty-two Broadway Co.*, 239 U. S. 69, *supra*, where this Court, considering the Corporation Tax Act of 1909, held that Congress has power to adopt a basis of distinction between corporations carrying an indebtedness that exceeds the amount of the capital and those that do not, and that the provision of the Corporation Tax Act limiting the amount of interest deductions to that paid on so much of the indebtedness as did not exceed the capital stock was not an arbitrary classification.

In *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, this Court held that there is no constitutional objection to distinctions in classifying income for tax purposes where the distinction has a reasonable basis. In considering the question, it was said (p. 25):

> Besides this demonstration of the want of merit in the contention based upon the progressive feature of the tax, the error in the others is equally well established either by prior decisions or by the adequate basis for

> classification which are apparent on the face of the assailed provisions, that is, the distinction between individuals and corporations, the difference between various kinds of corporations, etc., etc. *Knowlton* v. *Moore, supra; Flint* v. *Stone Tracy Co., supra; Billings* v. *United States, supra; National Bank* v. *Commonwealth,* 9 Wall. 353; *National Safe Deposit Co.* v. *Illinois,* 232 U. S. 58, 70. In fact, comprehensively surveying all the contentions relied upon, aside from the erroneous construction of the Amendment which we have previously disposed of, we can not escape the conclusion that they all rest upon the mistaken theory that although there be differences between the subjects taxed, to differently tax them transcends the limit of taxation and amounts to a want of due process, and that where a tax levied is believed by one who resists its enforcement to be wanting in wisdom and to operate injustice, from that fact in the nature of things there arises a want of due process of law and a resulting authority in the judiciary to exceed its powers and correct what is assumed to be mistaken or unwise exertions by the legislative authority of its lawful powers, even although there be no semblance of warrant in the Constitution for so doing.

Instances of somewhat similar classifications in the Revenue Acts are those based upon the amount of taxpayer's invested capital (Section 201 of the Revenue Act of 1917; Sections 301 and 311 of the

Revenue Act of 1918, *supra*; Sections 301 and 312 of the Revenue Act of 1921, *supra*), and also those based upon the distinction between income earned by capital and income earned by labor (Section 209 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 263; Section 209 of the Revenue Act of 1926, c. 27, 44 Stat. 9, 20, U. S. C. App., Title 26, Sec. 940; and Section 31 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 804, U. S. C., Supp. III, Title 26, Sec. 2031).

The taxpayer argued in the court below that the interest expenditure here involved should be allowed because the primary purpose of his borrowing was to produce taxable and not tax-exempt income. The record shows only that his net income (excluding interest received from, and interest paid to carry, tax-free municipal securities) was $28,551.94. It shows also that the entire amount of interest so paid by him was paid to purchase or carry municipal, county, and State bonds. If any part thereof was properly chargeable to other purposes the amount of it does not appear. In any event, taxing statutes can not be applied with mathematical exactness. The circumstance that here the taxpayer paid more interest than he received is entirely fortuitous. That the statute may work an occasional hardship in its reasonable application is not sufficient to condemn it. In its general application the statute does not place the taxpayer at a disadvantage, but merely fails to give him an additional advantage.

Every presumption is in favor of the constitutionality of an Act of Congress. *Nicol* v. *Ames*, 173 U. S. 509; *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *St. Louis S. W. Ry.* v. *Arkansas*, 235 U. S. 350, 369. We submit that the taxpayer has failed to show the unconstitutionality of the statute here involved.

CONCLUSION

It is respectfully submitted that the decision of the Circuit Court of Appeals should be reversed.

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